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USAID/Sri Lanka: Economic Growth & Conflict Assessment

1. Introduction

This report presents the findings, conclusions and recommendations from an Economic Growth and Conflict Assessment sponsored by USAID/Sri Lanka in October/November, 2006. The report is based on a field assessment conducted by Bruce Bolnick of Nathan Associates on behalf of USAID/EGAT, Naren Chanmugam of USAID/Nepal, and Judith Dunbar of USAID/DCHA/CMM, with support and input from Dick Edwards, Lionel Jayaratne, and Mark Sorenson from USAID/Sri Lanka. The assessment team would also like to thank the USAID/OTI program in Sri Lanka for their substantive and logistical support in this assessment. The report also draws upon the Sri Lanka Economic Performance Assessment (EPA) conducted by Nathan Associates on behalf of USAID/EGAT under the Country Analytic Support (CAS) Project.

The goal of the assessment was to develop recommendations for a robust yet conflict-sensitive approach to economic growth programming for USAID/Sri Lanka. The assessment team carried out research and fact finding in Sri Lanka and Washington, DC. The Economic Performance Assessment processed and summarized recent economic and conflict data from public sources as background for the assessment. The assessment team conducted over XXX interviews with private sector, NGO, government and civil society representatives across Sri Lanka, including Colombo, Kurunegala, Kandy, Moneragala, Pottuvil, Hambantota, Matara, Galle, Vanatha Villu, Mahavilachchiya, Thantrimale, Anuradhapura, and Trincomalee.

This report first presents analysis of the current economic and conflict situation. It next provides recommendations, including potential program areas, program implementation approaches (including how and where to implement the program), linkages across the USAID portfolio, and possible program mechanisms.

Recommendations summary

Based on the analysis below, the assessment team concluded that USAID should pursue a program that promotes sustainable and equitable economic growth through private sector development that delivers major benefits to conflict-strategic regions and populations in support of a durable political solution to the conflict. By ‘conflict-strategic’, we mean people and geographic areas that are either directly impacted by the war, or are critical to successful peace negotiations.

The program should engage these people and regions in two ways. First, it should work to improve private sector practices at the base level of supply chains in the rural sector, particularly focusing on agriculture, agribusiness, information and communications technology (ICT), and non-farm activities. For example, it might work with smallholders producing fruits and vegetables to improve their productivity or reduce their post-harvest losses. This engagement should be designed to produce a sustainable improvement in livelihoods in these regions. Second, the program should enable local actors, including both the private sector and local government, to engage in and eventually drive the national policy dialogue on economic issues that affect them. For example, the program could work with local chambers of commerce to engage national actors to lobby for trade facilitation reform. It might also engage national actors to support local actors lobbying for conflict-sensitive approaches to economic development issues, including planning of major infrastructure projects like Trincomalee harbor.

2. Conflict analysis

A number of actors have done extensive conflict analysis of Sri Lanka, which this report draws upon. In particular, the assessment team looked at prior reporting by USAID, the conflict analysis in the EPA by Nathan Associates et al, as well as volumes one and four of the six-volume *Sri Lanka Strategic Conflict Assessment 2005* by The Asia Foundation and other donors. The report uses these analyses as a foundation, and then adds data collected from interviews in the field. This section provides a brief summary of the history of the conflict to provide context, and an analysis of the underlying causes of the conflict as they relate to economics.

The basic causes of the initial conflict are well documented. In 1956, the Sinhalese government passed a 'Sinhala-only' law, effectively excluding the substantial Tamil minority from positions in government. This was a reaction to a British policy of divide and rule during the colonial period that gave advantage to the Tamil minority in jobs and education. It was followed by a nationalization policy in the 1960s and 1970s that further antagonized and excluded the Tamil population. In the 1980s long-simmering tensions erupted into a full blown civil war between the government and the Liberation Tigers of Tamil Eelam (LTTE). Successive attempts at peace talks (1985, 1994, 2000) failed, but a ceasefire was negotiated in 2002. Those talks also broke down in 2003, but both sides continued to declare their respect for the ceasefire in spite of intermittent outbreaks of violence.

After the 2004 tsunami, negotiations around the control of aid resources broke down when Sinhalese nationalist southern groups, particularly the JVP, protested the sharing of aid resources with the LTTE. The breakdown of this agreement foreshadowed the increasing tensions between the two groups that have led to the current escalation of the conflict. After elections in November 2005 (in which the Tamils in LTTE-controlled areas did not participate), the new government and the LTTE began to harden their negotiation positions. The Muslim population, which has been torn between the Sinhalese and Tamils, has become more vocal about their interests in recent years, and should be viewed as a significant party to the conflict.

The peace process in Sri Lanka has taken a marked turn for the worse in 2006. Since April increasing LTTE attacks have led to escalating violence in the north and east, leading to further displacement of communities, human loss, and hardening positions in all parties. Recently the government, the LTTE and the breakaway Karuna faction all have been accused of recruiting child soldiers to support their cause.[1] Peace talks in Geneva in October failed when the government refused to reopen the A9 to Jaffna, although a few weeks later they did agree to temporarily open the road for humanitarian supplies.[2]

[1] See BBC News, "Sri Lanka youth 'seized to fight'", 2006/11/13, available at http://news.bbc.co.uk/2/hi/south_asia/6144200.stm.
[2] See BBC News, "Sri Lanka to open road to Jaffna", 2006/11/20, available at http://news.bbc.co.uk/2/hi/south_asia/6164268.stm.

All sides claim to remain committed to the peace process, and occasionally make overtures like the opening of the Jaffna road. Still, given the current situation, the failure of the parties to address the underlying grievance central to the conflict, and the lack of a meaningful dialogue around peace, USAID is likely to face an increasingly difficult programming environment as it moves into its new strategy in 2008.

A durable peace will require 'a reconstitution of the relationship between the rulers and the ruled in which the principles of pluralism, democracy, human rights and social justice are important.'[3] The conflict described above is a result of deeply held grievances by both sides that have manifested themselves in a government that institutionalized discrimination, a rebel movement that assassinates dissenters, and an alienated Muslim population that is becoming increasingly vocal about its interests. Indeed the grievances of the Muslim population have been largely neglected until recently, as demonstrated by the longstanding abandonment of Muslim IDPs forced out from the north by the LTTE who are still languishing in camps north of Puttilam. Addressing the conflict will require changing the system in a way that addresses the grievances and protects the rights of all sides. Economic issues are both a cause of these grievances and a manifestation of the larger governance problems.

The EPA conducted by Nathan Associates demonstrates how economic inequality has exacerbated the polarization of the country along ethnic and religious lines. Sectarian tensions have risen in the last three years, as measured by the Fund for Peace's Conflict Assessment Tool. Regional disparities in income and unemployment feed these tensions. Employment data demonstrates that unemployment is much higher in the north and east, strongholds of the LTTE, than in the rest of the country. It is also significantly higher in areas supporting the JVP nationalist movement. Poverty rates are also significantly higher in these regions than in the well-developed Western Province. The EPA finds that the LTTE and the JVP are able to mobilize young people around the grievances caused by the lack of employment and economic disparity. The sense of exclusion and alienation in LTTE-controlled and JVP-supporting areas resulting from the concentration of development resources in the West has further fueled the tensions that make the conflict so intractable. It also leads to the perception that the state does not manage economic disparity well, weakening its legitimacy.

The government's history of large infrastructure projects like the Mahaweli Irrigation Project feeds this perception. The Mahaweli project is cited by conflict analyses as a key source of tension. Sinhalese displaced by the irrigation program were resettled into areas considered by the Tamils as part of their homeland. This resettlement is characterized by many as a 'Sinhalese land grab,' or colonization. The Mahaweli project is a particularly large example of the discriminatory practices that undermine the government's stated vision of a unitary state for all the people of Sri Lanka.

Interviews conducted by the assessment team indicate that these problems persist. The most egregious example of conflict-insensitive development planning on the

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[3] Sunil Bastian, *The Economic Agenda and the Peace Process: Part of the Sri Lanka Strategic Conflict Assessment 2005*, The Asia Foundation et al, 2005.

government's part described to the team was the plan for Trincomalee harbor. Government representatives described a plan for an area deeply traumatized by the war that would involve displacing Muslim and Tamil communities to make way for power plants and harbor facilities, turning the multi-ethnic city of Trincomalee into a high security zone, and relocating the seat of government to a Sinhalese dominated JVP stronghold. While the written details of the plan were not provided to the team, the description sounded like a recipe for increasing communal tensions dramatically.

At the same time, the state had conducted an impressive community-based program to set priorities for organizing the chaotic post-tsunami assistance in the same area.[4] The lessons from that process should be applied to future development programs in Trincomalee and other regions that have been affected by the conflict, including any planning for major infrastructure.

The analysis of the conflict indicates that while regional economic inequality is fuel for the tensions, the solution to the inequality and the conflict will be political. Truly addressing regional inequality will require devolving power to local governments, as well as some measure of fiscal decentralization. In the Sri Lankan context these are profoundly sensitive issues as they are inextricably tied to the peace negotiations and the question of autonomy for the north and east.

The approach recommended in this report focuses on reaching out into less developed regions to try to alleviate some of the disparities with the West. This approach will build capacity in local populations to pursue sustainable economic activities, and to advocate for their interests at the local and national level. It will also build linkages between the center and the periphery to help open lines of constructive communication and build strong economic ties between private sector actors. But in the absence of a larger political peace process that addresses the devolution of power and elicits a commitment to peace from both sides, progress will be limited both in economic and conflict terms. Economic growth programming can contribute to building social capital and economic security to help open space for a political solution, but on its own it will not resolve the conflict.

3. The economic situation

This section examines the recent performance of Sri Lanka's economy, as a backdrop to assessing future priorities for USAID's Economic Growth program, through the conflict lens. The discussion draws heavily on an *Economic Performance Assessment* (EPA) that was undertaken as an input to the present report.[5] The EPA employs a Country Analytic template developed by the EGAT Bureau to assess the strengths and weaknesses of a given economy using international benchmarking methodology. For Sri Lanka, the

[4] See RADA community development plans – MARK SORENSON HAS THE COPIES OF THESE PLANS PROVIDED TO THE ASSESSMENT TEAM – MARK, CAN YOU PROVIDE US THE REFERENCES? THANKS!

[5] Nathan Associates, *Economic Performance Assessment: Sri Lanka* (November, 2006). The report has been produced under the Country Analytic Support (CAS) project, Contract No. GEG-I-00-04-00002-00, through the EGAT Bureau. The full CAS report is provided as an Annex to the present paper.

Country Analytic template was customized to include an analysis of the links between economic performance and conflict risk.

At the macro level, the economy has maintained a remarkable growth record, considering the conflict situation. Since 1990, real GDP has increased at an average rate of nearly 5 percent per year. From 2002 to 2005, with a cease-fire in place, growth averaged 5.8 percent. As a result, per capita GDP increased from under US$ 500 in 1990 to an estimated US$ 1200 in 2006. In constant-price terms, average incomes rose by two-thirds during this time frame.[6]

Despite the resurgence of violence, growth accelerated to a rate of nearly 8 percent during the first half of 2006. This surge has been fueled by post-tsunami reconstruction, large remittances from citizens overseas, and expansionary fiscal policy. Unfortunately, the building blocks for *sustaining* rapid growth – high levels of investment, and rising productivity – are not in place. This is critical, because 7 to 8 percent growth is essential for achieving faster poverty reduction to ease social and communal tensions. With the prevailing rate of 5 to 6 percent, poverty has been declining very slowly.

This shortfall in growth performance is due at least in part to the conflict, which has diverted resources away from productive activities and essential public services, while adding uncertainty to the investment climate. Calculations by the Institute of Policy Studies suggest that the war caused a loss of up to two full years worth of GDP between 1982 and 1996.[7] Moreover, the greatest risk facing the economy over the next few years is the possibility that violence will escalate and spread.

Another central concern is the skewed distribution of economic benefits. According to the 2002 Household Income and Expenditure Survey (HIES), per capita income in the dominant Colombo district was more than twice as high as in the poorest district of Ratnapura, at LKR 4923 and LKR 2004 per month, respectively. These imbalances are reflected in the poverty headcount, which ranged from 6 percent in Colombo to 37 percent in Monaragala and Badulla. Overall, 22.7 percent of the population lives below the absolute poverty line (defined by a nutrition-based anchor). Notably, the HIES does not report data for the North and East, which are the most conflict-affected regions.

The HIES also reveals a sharp split between urban, rural, and estate households, with respective per capita income levels of LKR 4997, LKR 2835, and LKR 1663. The disparities, too, are reflected in the incidence of absolute poverty, with rates of 7.9 percent, 24.7 percent, and 30.0, respectively. This is very important because nearly 80 percent of the population lives in rural areas, and agriculture has been a lagging sector for many years. Furthermore, much of the support for militant movements emanates from impoverished rural areas.

Other major problems identified in the *Economic Performance Assessment* involve macroeconomic management, the business environment, the infrastructure, and the

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[6] Source: IMF, World Economic Outlook database, September 2006.
[7] Nisha Arunatilake, Sisira Jayasuriya, and Sasam Kelegama, *The Economic Cost of the War in Sri Lanka*, Institute of Policy Studies, January, 2000.

agricultural sector. All of these issues are associated, at least indirectly, with the conflict situation.

The macroeconomic picture is cloudy at best, mainly due to a budget deficit above 8 percent of GDP in each of the last six years. The deficit is a product of weak revenue mobilization and expansionary spending policies, including a rapidly rising civil service wage bill, and interest expenses that absorb one-fourth of total expenditure (mainly from domestic financing of prior deficits). The renewed conflict will place further pressure on the budget. After peaking at 6.0 percent of GDP in 1996, defense spending fell to 4.5 percent of GDP in 2000, and 2.7 percent in 2003. This trend is likely to reverse, and either squeeze the funding for other public services, or worsen the deficit.

On the revenue side, the government has taken steps to improve performance by increasing taxes. This should help the fiscal outlook in the short run, but it is the opposite of best-practice in terms of promoting growth; the standard prescription for raising revenue is to *reduce* tax rates while broadening the tax base by scaling back tax incentives and strengthening tax administration.

The clearest sign of a macroeconomic problem is inflation, which climbed to double digits in 2005, and reached 17.2 percent in October 2006.[8] This is widely blamed on fuel and power price adjustments. Yet other countries faced the same pressures without a large jump in inflation. The central bank has been leaning against the inflationary wind by raising interest rates. Nonetheless, the fundamental problem is that the money supply has been increasing by nearly 20 percent per year for the past two years, far too fast for price stability. The great danger is that the elevated inflation rate may set off a wage-price spiral that would greatly increase the economic cost of bringing inflation back under control. Meanwhile, inflation is pushing up *nominal* interest rates, which worsens the budget outlook, while simultaneously reducing *real* interest rates, which encourages inefficient investment. High inflation is also causing an appreciation of the *real* (price adjusted) exchange rate, undermining the competitiveness of domestic products in both international and local markets. If not corrected quickly, these fiscal and monetary imbalances may jeopardize the prospects for continued growth, possibly triggering a new wave of political tension. At the same time, the conflict makes it more difficult to tighten the fiscal belt, not only because defense expenses will be rising, but also because populist expenditure policies are an expedient tool for maintaining political support in the face of heightened security risks.

Sri Lanka's business environment is favorable, in many respects. This is evident in the World Bank's composite index of Doing Business indicators, for which Sri Lanka ranks 89th out of 175 countries. This is a very good result, relative to most lower-middle income countries. Nonetheless, many areas bear improvement, and there are several notable weaknesses in the business environment. Thus, Sri Lanka gets an extremely unfavorable rating on the difficult of firing workers. This is a very sensitive issue, especially in a country with militant unions and an undercurrent of tension due to the conflict. Nonetheless, regulations that impose high costs and cumbersome restrictions on firing

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[8] This is the figure for the 12-month change in the Colombo Consumer Price Index. Other price indices show lower inflation rates, but nearly all are in double digits. Source: Central Bank of Sri Lanka

create a strong *disincentive* for job creation in the first place. This is a critical problem, given that youth unemployment is very high, and that disaffected youths are prime fodder for communal extremism. Other notable weaknesses include the time required to enforce a standardized contract (837 days), and the time required to start a business (50 days).

Looking beyond the familiar Doing Business indicators, the World Economic Forum's survey of executive opinion reveals that the businesses view terrorism as a significant problem to operating in Sri Lanka. In addition, corruption appears to be growing concern. Sri Lanka's score on the Corruption Perceptions Index from Transparency International (TI) has been deteriorating steadily, from 3.7 in 2002 to 3.1 in 2006 (on a scale of 1 to 10, with 10, from most to least corrupt). This places Sri Lanka 84th out of 163 countries, which looks good. Nevertheless, the decline is a danger sign, especially in light of the growing military presence, and the recent tendency to introduce new subsidies and controls, all of which create new avenues for corruption. Furthermore, a score of 3.1 is barely above TI's threshold of 3.0 for "rampant" corruption. The fact that other countries look worse is no cause for comfort.

Infrastructure deficiencies are yet another major impediment to investment, productivity, growth, and regional equity. An *Investment Climate Assessment* (ICA) produced by the Asian Development Bank and the World Bank in 2004 identified the high cost and erratic quality of electricity is the number one constraint on urban manufacturing; electricity supply was also a leading constraint for rural enterprises, though it ranked slightly below the transportation system, the cost and availability of finance, and weak market demand (which is related to the transportation system, as well as low purchasing power in regional markets). Focusing on transportation, the ICA reports that 90 percent of paved roads are in poor condition because of lack of maintenance. This observation points to a basic problem with the budget process: inadequate funding of the recurrent costs of maintaining infrastructure. High defense expenditures undoubtedly compound the problem.

Deterioration of the road network is partly a reflection of poor rail infrastructure. In this area, Sri Lanka gets a dismally low mark of 2.5 (out of 7) in the World Economic Forum's Global Competitiveness Report. The rail system now handles only five percent of freight transportation.[9] The rail problems are another clear sign of inadequate financing for maintenance. The prolonged conflict has also had an impact, by disrupting several major transport corridors.

Another critical infrastructure weakness is Internet connectivity. Even though the number of Internet users per 1,000 people has been growing rapidly, reaching 14.5 in 2004 (latest data), this is still extremely low by benchmark standards. Internet coverage is especially limited in rural areas, where most of the people reside. The worst problems, however, are in conflict-affected regions. With a highly educated labor force, Sri Lanka has great potential in the information technology sector. In addition, most businesses require high quality connectivity to be internationally competitive.

[9] World Bank/Asian Development Bank, *Investment Climate Assessment*, 2004, p. E-II.

The *Economic Performance Assessment* also points to stagnation in agriculture as a drag on growth and a source of inequality. While agriculture now accounts for only 17 percent of GDP, one-third of the labor force still depends on the sector for their livelihood. The average yield in cereal production is quite high, at 3,438 kilograms per hectare in 2005. However, value added per worker in the sector has increased by a dismal 0.4 percent per year over the past five years. Moreover, FAO data show that crop production is virtually unchanged from fifteen years earlier. Poor infrastructure is a major part of the problem, particularly roads, irrigation systems, and rural markets. But the policy environment is also an issue, with various subsidies, price controls, and restrictions creating incentives that retard diversification from paddy to higher value crops. In addition, the conflict has limited activity to subsistence cultivation in large parts of the north and east.

Weak performance in agriculture is especially troubling in conjunction with the very low rate of urbanization (21 percent) in Sri Lanka, and widespread rural poverty that provides a breeding ground for communal militancy. Rural development is therefore a priority concern. However, this is not just an issue of agriculture. Boosting incomes and expanding opportunities in rural areas also requires initiatives to reduce post-harvest losses; link farmers to supply chains serving major markets; overcome key constraints on the business environment; and develop non-farm rural enterprises. On the last point, it is interesting to note that even in largely rural districts, less than half the labor force is occupied in agriculture. The sole exceptions are Monaragala and Anuradhapura, where agriculture absorbs 62 percent and 54 percent of the workers, respectively.[10]

For sake of brevity, this discussion of economic growth problems is not comprehensive, but it does cover the central issues identified in the *Economic Performance Assessment*. To paint a balanced picture, it is also important to point out that Sri Lanka has very important positive attributes, as well. These include excellent performance on most socio-economic indicators, including health care, school enrollment at all levels, and gender equity (with the exception of labor force participation). In addition, the age dependency rate is relatively low, environmental indicators are reasonably good (except for water stress), export growth has been robust, the country attracts a huge flow of remittances from workers overseas, and external debt service costs are moderate.

Viewing the overall economic conditions through a conflict lens, there are clear signs that the conflict has, to varying degrees, retarded growth, impaired progress on poverty reduction, and accentuated regional and sector disparities. At the same time, the prevalence of poverty and economic disparities have contributed to conflict risk by breeding grievance and disaffection, thus empowering militants on both sides. These interactive effects make it more difficult to break the economic grievance-conflict cycle. But they also offer hope that a breakthrough in the peace process may facilitate more rapid and equitable growth, which could help to solidify progress on the political front.

For now, the economic grievance-conflict cycle appears to be on a downward spiral. This can be seen in the Sri Lanka's ratings on a Conflict Assessment System Tool (CAST) developed by the Fund for Peace, in conjunction with the Carnegie Endowment for

[10] Department of Census and Statistics, *Annual Report of the Sri Lanka Labour Force Survey: 2004*, September, 2006.

Peace.[11] The index uses twelve social, economic, political, and military indicators to rank 148 countries in terms of risk. The overall Failed State Index (FSI) is an unweighted sum of the 12 CAST indicator scores, with 120 being the worst possible total. A score of 95 or higher falls into the category of "critical" danger. For this report, FFP conducted a special analysis of data for the first nine months of 2006 for Sri Lanka. Sri Lanka's score is 95.3. In 2002 and 2003, the country's score was in the low 80s. Thus the analysis shows a marked increase in conflict risk over the past three years.

The CAST indicators shed light on the underlying problems. The economic factors include disparities in income and employment, tensions due to population displacement, and stresses associated with external political actors. The latter factor relates to tensions arising from the management of post-tsunami assistance from the donor community.

In short, with Sri Lanka again on a *conflict* path, the issue of *who benefits* becomes a major factor for the EG program design. To be sure, there is no reason to expect that a reorientation paying more attention to distributional effects will have a major influence on the course of the conflict. At this point, the fighting revolves mainly around issues of power and autonomy. Nonetheless, a conflict-sensitive focus on the distribution of benefits can help to soften support for the militants by enhancing economic opportunities for disadvantaged populations and reducing tensions due to economic displacement. At a minimum, the "do no harm" principle for donor operations in a conflict region suggests that the program should be carefully structured to ensure that the distribution of benefits will not, in itself, heighten the sense of injustice and anger among disaffected groups.

Even through the conflict lens, the EG program must still deliver a strong economic impact. But the considerations examined above suggest that the program should also aim to reduce regional imbalances, youth unemployment, and economic displacement, to help mitigate economic grievance. By the same token, it is also important for the program to empower local agents in strategic regions to influence the local development agenda, and exercise greater voice in the national dialogue on economic reforms. Finally, a conflict-sensitive program should establish a foundation for rapid revival of conflict-affected regions once peace breaks out.

4. Recommendations

This section provides recommendations for a program focus on private sector development, sectors and tools for engagement, programmatic adaptation to different conflict scenarios, and how and where to engage to ensure conflict sensitivity.

Program focus: private sector development

The principal recommendation of this report is that USAID/Sri Lanka should maintain its focus on Private Sector Competitiveness (PSC) as the priority Program Area for EG funding, while incorporating a new conflict-sensitive emphasis on the regional

[11] "The Failed States Index," *Foreign Policy*, July/August 2006. Each indicator is scored on a scale of 1-10 (with 10 being the worst) based on a computerized content analysis that processes thousands of news articles and documents from around the world on a daily basis and combines the results of this analysis with the hard quantitative data that are available. For more details, see the *Economic Performance Assessment: Sri Lanka*, which accompanies the present paper.

distribution of benefits. This section presents the justification for this recommendation, and also discusses several counter-arguments or caveats with implications for the program design.

As a starting point, USAID has a widely recognized comparative advantage among donors in promoting private sector competitiveness in Sri Lanka. It makes sense for USAID to build on existing mechanisms. More fundamentally, it makes sense to focus on mobilizing private initiative as the main engine for growth, job creation, and income generation in conflict-strategic regions and throughout the country. In target regions, the PSC program can help develop private enterprise (including farms) by supporting innovations that enhance productivity and add value at the grass-roots end of the value chain, and by establishing sustainable links between local enterprises and broader national and international markets. USAID can also help particular industry groups or clusters engage more effectively in dialogue with the government, at both the local and national levels, to reform key policies and institutions that impede growth.

To leverage USAID resources and maximize the program benefits, PSC interventions should aim to develop viable business opportunities that can be widely replicated by the private sector. In this way, the initiatives will generate not only a significant yield for the immediate beneficiaries, but also create market-based incentives for additional investments that can multiply the yield many times over. Such initiatives can also provide a model for the rapid revival of private investment in conflict-affected areas once security conditions improve.

Text Box 4.1 (below) provides three examples from USAID's current PSC program (called The Competitiveness Program, or TCP) showing how exporters at the down-stream end of the national value chain have mobilized resources to provide investments, technology, and training that will enhance productivity, create jobs, and improve living standards in up-stream rural areas. Although TCP was not designed to provide support in conflict-strategic regions, the cases show how the value-chain approach can benefit rural target groups, even in disadvantaged regions like Moneragala. They also demonstrate the importance of working with larger businesses from the core economic centers to develop viable innovations that reach the grass-roots level. It is worth noting, too, that each of these innovations took several years to move from concept to plan to implementation. While every project seeks "quick wins," many private sector development interventions take much more time to show results.[12]

[12] Indeed, activities that can be implemented quickly are often those which are on the verge of occurring anyway. In this case, benefits cannot properly be attributed to the program. For example, a careful evaluation of a World Bank program providing enterprises in Mauritius with matching grants for technology investment found that the program largely funded investments that were already under consideration and would have been undertaken even without the grants. Thus, the program's actual impact was very limited, despite a laudable record of rapid disbursements and visible economic improvements for client enterprises. See Tyler Biggs, *A Micro-econometric Evaluation of the Mauritius Technology Diffusion Scheme*, World Bank, November, 1999, available at: ww1.worldbank.org/rped/documents/rped108.pdf .

Text Box 4.1: A Value Chain Approach to Rural Development -- Examples from The Competitiveness Program (TCP)

USAID's main Economic Growth project in recent years, called The Competitiveness Progam (TCP), has been working with eight industry clusters that account for 23 percent of the total workforce. Since the project's inception in 2000, export earnings of these sectors have grown at an average rate of 8.8 percent per year, and the value added component has increased by 50 percent; by comparison, the value added component for other sectors increased by only 27 percent. Four of the clusters -- Coir, Rubber, Spices and Tea -- involve activities with a strong rural out-reach. This text box cites three examples in which exporters at the down-stream end of the value chain have invested in promoting rural up-stream development that will increase exports, enhance value added, create new job opportunities, and improve rural standards of living. While support to the current TCP programs will end in FY2007, it may make sense to continue support in the clusters identified above, and to apply lessons learned from TCP to agribusiness, non-farm activities and ICT.

Coir Research, Development and Training Center (Model Mill Project)

On August 24, 2005 the Coir cluster completed an agreement to establish a Coir Research, Development and Training Centre involving the Coir Council International (CCI), the Coconut Development Authority (CDA), the Coconut Research Institute (CRI) and the Industrial Technology Institute (ITI). The signing facilitated the release of a US$480,373 grant from the Common Fund for Commodities (CFC). The full cost of this public-private partnership is US$730,000, with Sri Lankan counterparts funding the balance. TCP supported the initiative through a long incubation period from concept to pre-implementation. The Centre is located on a small CDA coconut estate in Dunkannawa, 50 km north of Colombo. It will consist of a mill housing a full fiber processing line, and a small on-site fiber lab, plus meeting and training facilities. The focus is to develop technology and training programs to increase productivity and quality of coir mills in all suitable areas of Sri Lanka, to the benefit of rural entrepreneurs, their employees, and the coconut farmers.

Moneragala Rubber Development Program (MRDP)

This program was developed by the Rubber cluster to resolve a critical supply chain problem. Sri Lanka's rubber industry consumes more that 80,000 metric tons of raw rubber per year, with demand growing by 10 percent per year. An adequate and consistent supply of raw rubber for value addition is essential for sustaining rubber industry competitiveness. Yet raw rubber production in Sri Lanka has been on the decline since the 1980s, forcing rubber product manufacturers to import raw significant volumes at high cost to cover the shortfall. One leading manufacturer has expanded to Thailand to circumvent the scarcity of raw rubber in Sri Lanka. To alleviate these constraints, the Rubber Cluster recommended the expansion of rubber plantations to the Moneragala region. The cluster formed a coalition of companies to invest in plantations, and convinced the government of the value of the program. The Ministry of Plantation Industries has worked closely with the private sector. The ensuing partnership has been highly effective, and has drawn IFAD support for a joint investment of US$35 million. This initiative will create over 700 jobs, with wide multiplier effects, in one of the poorest districts in Sri Lanka.

Spices -- Good Manufacturing Practices for Cinnamon Processing

The Spice Council (TSC), in collaboration with the EDB, GTZ, the Cinnamon Association of Sri Lanka, and a private cinnamon grower/processor, set up a cinnamon-processing center using Good Manufacturing Practices (GMP) at Kosgoda, Balapitiya, in the Southern Province. The center opened on August 12, 2005. This is the first processing center of its kind in Sri Lanka, and is open for anyone in the industry to visit, observe, and replicate. SGS Lanka (Pvt) Ltd, a member of TSC, carried out the evaluation and conferred the GMP certification to "Dasanayake Walauwa Cinnamon Plantation." The cost of the project was Rs. 3 million, of which Rs. 1million was provided by the National Council for Economic Development (NCED) as a grant through the EDB.

In reaching this conclusion, the assessment team encountered and considered several important counter-arguments or caveats. Perhaps the most serious argument is that USAID's while relatively small EG program may mitigate conflict factors at the local level, it cannot be expected to have a significant benefit in resolving the national conflict absent a political solution, even with the proposed distributional orientation. Yet the regional focus will exclude many interventions with high prospective rates of return, if the benefits were concentrated in prosperous parts of the country. The net effect of applying the conflict lens may therefore be to limit the economic impact of the program without improving the overall conflict situation.

The assessment team's response to this argument is that maximizing the economic impact without regard to distributional effects is not an appropriate objective under current conditions in Sri Lanka. And while we agree that the EG program is unlikely to mitigate the conflict or soften communal militancy on a national scale, it still is important to introduce distributional objectives in order to minimize the risk of *accentuating* disparities and grievances.

Indeed, the concern about accentuating grievances prompted several well-informed sources to question the advisability of fostering economic development even in the rural south or in border areas. The argument is that programs to stimulate growth in these target areas, however well intentioned, will increase disparities with the north and east. As a result, the program will have the appearance of rewarding the government, and may intensify disaffection in the LTTE-controlled regions. The effect may be to harden positions on both sides, rather than reducing tensions.

This concern is leading some donors, such as SIDA and GTZ, to consider cutting back on development assistance altogether until the peace process is back on track. USAID prefers to stay engaged in the economic development process despite the difficult security situation. The assessment team concludes that the latter course is appropriate, on the condition that the EG program is structured to minimize the risk of inflaming tensions. This is partly achieved through providing support to the private sector, rather than to the government itself. It is also achieved by working in the communities most affected by the conflict, those on the border. USAID is already engaged in these communities through OTI and the DG program. Working in these locations also positions USAID to move rapidly into the north and east if and when operation space opens. Finally, the program can help to ease tensions by collaborating with enterprises representing all of the communities, facilitating inter-group cooperation, promoting bilingualism, and enhancing the voice of entrepreneurs from disadvantaged groups in the policy dialogue. If well designed and implemented, the EG program may have an impact on mitigating local level tensions while providing economic benefits that could serve as a replicable model for other parts of the country.

We further propose including in the program an effort to work with business groups in the north and east, *if at all possible*. Even though the economic impact of operating in conflict areas may be minimal and difficult to sustain, USAID should demonstrate through this program its commitment to strengthening the private sector on both sides of the conflict line. Talks are currently underway between the Sri Lankan government and the World Bank Multilateral Investment Guarantee Agency (MIGA) on initiating a USD40 million fund to encourage investment in the north and east.[13] If this program comes through, USAID programming can capitalize on it as an incentive for companies expanding into this region.

Another contention relates to the economic viability of private sector development in impoverished regions. The argument is that remote and impoverished regions lack many of the necessary conditions for viable private investment. Inherent problems include, among others: very weak local demand due to low incomes and low population density; high transportation and transaction costs for accessing inputs or selling products to major markets; poor infrastructure; lack of a skilled workforce; and the absence of supporting business services ("economies of agglomeration"). Overcoming these deficiencies is a long-run proposition. Meanwhile, efforts to benefit remote disadvantaged areas through private sector development may yield meager results. The implication of this argument is that the EG program can best benefit disaffected groups in rural target areas – especially youth – by stimulating job growth where the economic geography is most favorable for private sector development, while facilitating migration and skills formation linked to actual employment opportunities.

While investment opportunities are undoubtedly more favorable in major economic centers, the assessment team strongly believes that USAID can identify viable PSC activities that benefit rural target regions, through a value chain approach. Possible interventions include: encouraging diversification into new cash crops; reducing post-harvest waste and spoilage; linking poor farmers with major corporations through out-grower schemes; developing rural agro-processing operations; establishing service enterprises serving rural businesses and households; creating rural information and telecommunications centers; or introducing IT outsourcing operations in locations with suitable internet access. Moreover, USAID intervention may be most critical in areas where economic opportunities are less clear-cut and private investment less likely to blossom on its own accord. In any case, it is essential to include a workforce development component of the PSC program, with the flexibility to address critical labor requirements at both ends of a value chain.

Another consideration is that the economic disadvantages of working in rural districts may elevate the program risks. The risks can be attenuated, however, by diversifying both the financing and the activities. On the financing side, the EG program should require co-financing from private sector beneficiaries, perhaps on a sliding scale. The program should also seek to mobilize broader GDA participation. On the activities side, the program should adopt a risk capital approach by investing in a diversified "portfolio" of interventions, rather than pursuing a narrow range of pre-conceived menu of specific activities. All of the interventions, of course, should be clearly justifiable *a priori*, and

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[13] Lanka Business Online, "Sri Lanka moots World Bank fund to lure investments to the war torn areas" 11/17/06, available at http://www.lankabusinessonline.com/fullstory.php?newsID=962480271&no_view=1&SEARCH_TERM=2.

will focus on the sectors outlined below; in the end, however, some interventions will be highly successful and others will not. With a flexible portfolio approach, the success stories will more than compensate for the other efforts that fail to deliver strong results.

A final point of contention is that other Program Areas may be more important than Private Sector Competitiveness for fostering growth and poverty reduction, even under the conflict lens. The assessment team examined all of the alternatives, and found no compelling case for recommending a major change in direction for the EG program at this time. The reasons are summarized briefly in Text Box 4.2.

In summary, the assessment team proposes what might be called a “trickle-up” strategy of promoting rapid growth and regional equity in Sri Lanka by fostering private sector competitiveness through selected value chains, with a focus on activities benefiting strategic rural areas. This strategy appears to be well suited for current conditions of conflict risk and political tensions. It offers considerable flexibility for modifying the specific set of activities to accommodate changes in the conflict situation. Finally, this strategy is not dependent on any specific government action or coordination. The recommendations below are flexible enough to partner with government to increase scope and build local capacity, while at the same time working with the private sector to ensure that activities continue even in the absence of a government partner.

The value-chain approach to private sector competitiveness is also well suited for delivering measurable results in terms of both economic impact and regional balance. The anticipated outcome will be a significant increase in investment, productivity, value added, income, and employment in strategic regions and at the national level. The program should deliver a high ratio of overall program benefits to program costs. Specific targets in each of these dimensions should be defined in the design phase of the program.

The next section provides more detail on recommended sectoral interventions, tools to promote a PSC approach to economic growth, and engaging the private sector in peace promotion. The section concludes by presenting criteria for where and how to engage in conflict-strategic areas.

Text Box 4.2: Reviewing the Menu of Economic Growth Program Areas

This report recommends a continuation of USAID's focus on Private Sector Competitiveness (PSC), with a conflict-sensitive emphasis on regional distribution. Is this the best use of EG funds? The assessment team examined alternatives, and found no compelling case for a major change in direction. The reasons are outlined briefly here, with reference to the *United States Foreign Assistance Standardized Program Structure* (October 20, 2006):

Program Area 1: Macroeconomic Foundations. The economic overview in section 3 showed that recent macroeconomic trends are highly problematic. Macroeconomic imbalances can undermine private sector growth, intensify political tensions, impose serious hardships on poor households, and trigger a militant posture by all sides. Available information, however, suggests that the government views the macroeconomic situation as being under control. Given the role of regional disparities in the conflict in Sri Lanka, the assessment team recommends engaging on macroeconomic foundations through the lens of PSC in conflict-strategic regions. There is an opportunity here to engage local actors in the national policy dialogue that could both improve policy and start drawing more productive attention to the needs of these regions.

Program Area 2: Trade and Investment. While these are vital areas for reform, the government is moving in the other direction, towards increased protectionism and greater control. Also, export promotion efforts of the current Competitiveness Program have been criticized for insufficient focus on the distribution of benefits. Again, the assessment team recommends addressing trade and investment issues through a PSC approach, by helping business groups pursue public-private dialogue to reform policies and institutions that impede the development of particular value chains.

Program Area 3; Financial Sector. A recent *Investment Climate Assessment* by the World Bank and ADB identified financing constraints as a leading problem for both urban and rural enterprises. Nonetheless, credit to the private sector is growing rapidly. Our recommendation is to address financial constraints in the context of specific value chains, rather than switching to a financial sector program as such.

Program Area 4: Infrastructure. USAID's EG program is too small to warrant an infrastructure focus. However, strategic infrastructure problems may be addressed in dealing with impediments to the development of particular supply chains under the PSC program.

Program Area 5: Agriculture. Agriculture is the most important source of livelihoods in the conflict-strategic rural regions, and productivity growth in this sector has been distressingly low. However, non-farm rural activities are increasingly important, even for the rural labor force. Also, rural development depends on establishing market links, and on non-farm investments that add value to farm products. Thus, the assessment team recommends targeting agricultural enterprises in strategic regions through a flexible PSC value-chain approach.

Program Area 6. Private Sector Competitiveness. *This is the recommended priority*.

Program Area 7: Economic Opportunity. As with Agriculture, the assessment team recommends addressing economic opportunity issues in strategic regions through a PSC approach that helps to develop viable opportunities for micro and small enterprise development in the context of the overall value chain.

Program Area 8: Environment. Apart from water supply problems (which are under consideration by the MCC and other donors), environmental issues are not major concerns at this time for economic growth or conflict mitigation.

Sectors

Agriculture-based value chains

Rural Sri Lanka is primarily agriculture based. Due to the conflict that has discouraged investment in other sectors, agriculture and fisheries are the only viable economic activity for most of the people in the North and the East. Traditionally, the North and the East were connected to larger markets in the south, and supplied fruits, vegetables and seafood. Although the conflict has restricted the movement of people and goods, there still is some trade taking place, and the challenge is to expand what is already going on, and to devise new methodologies to take advantage of existing opportunities.

The current TCP cluster work in spices, rubber and coir has potential to reach rural farmers in these conflict and poverty affected areas. The groundwork laid and lessons learned from the cluster approach in TCP could be used to develop an agroprocessing cluster-type activity.

Currently, a number of larger private sector organizations (Haylees, CIC, Cargills) do have farms and outgrower schemes in various parts of the county. USAID should partner with these firms to extend their reach into the more marginalized areas. Similarly, there are many other smaller private sector players – many of whom are members of the National Agribusiness Council (NAC), other chambers and association – who express interest in working more in the conflict affected areas. Possible interventions could include: organizing farmers groups to link up with the private sector; training in proper production and harvesting techniques; USAID-private sector joint development of collection centers and storage facilities for fruits, vegetables and seafood; and help with meeting grades and standards.

The former AgEnt program is fondly remembered by many involved in the agriculture sector, and successful components could be resurrected. For example, USAID could revive support for the NAC for closer coordination with the regional agricultural associations and for policy advocacy at the national level.

Selected non-farm activities

Labor force statistics confirm that agriculture-based value chains should be a primary engine for enhancing private sector competitiveness in conflict-strategic rural areas. Detailed data from the 2004 labor force survey show that even in the poorest districts like Monaragala, two-thirds of the workers earn their livelihood from agriculture.[14] Table xx shows the labor force figures for districts outside the relatively developed Western and Central provinces plus Galle in the Southern Province (which account, collectively, for 45 percent of the total labor force). However, the figures also show that non-farm activities are very important. Indeed, the labor force share in agriculture has steadily declined from 47 percent in 1990 to just 33 percent in 2004. In Sri Lanka, the trend out of agriculture has been accelerated by long years of disruption in rural districts due to the conflict, and by policy distortions that impede transformation within agriculture itself.

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[14] The "labor force" is defined in Sri Lanka to include anyone age 10 or over who is working or seeking work, including own-account workers in the informal sector and on family farms. Source: Department of Census and Statistics website.

Nonetheless, this pattern of labor force transition is typical of successful development. Indeed, the movement of workers into more productive non-farm jobs is a major source of rising national income. Thus, the rural focus of the PSC program should include interventions to develop non-farm business activities, as well as innovations in agriculture.

Many of the best opportunities for non-farm business development in rural areas will be associated directly with agriculture-based supply chains. Examples include small-scale processing, milling, or packing operations, transportation services, storage services, market information services, ice factories, fish net production and repair, and local production of packaging materials. Other opportunities may include village cellular phone and internet enterprises, vehicle repair and maintenance services, construction services, handicraft production, small scale mining and quarrying (where appropriate), aryuvedic health services, or vocational training enterprises.

District	Labor Force ('000)	% in Agriculture	% in Industry	% in Services
Southern Province				
Matara	378.0	48.3	19.3	32.4
Hambantota	244.8	42.2	23.3	34.5
Northern Province				
Jaffna	183.1	38.4	19.8	41.7
Mannar	29.5	49.1	12.1	38.8
Vavuniya	46.6	26.9	13.6	59.5
Mullaitivu	n/a	55.6	9.9	34.5
Kilinochchi	n/a	42.1	9.5	48.4
Eastern Province				
Baticaloa	159.7	32.6	23.3	44.1
Ampara	222.4	45.4	14.3	40.2
Trincomalee	125.8	30.2	12.8	57.0
Sabaragamuwa Province				
Kurunegala	730.7	28.9	29.5	41.7
Puttalam	299.2	31.7	27.3	41.0
North Central Province				
Anaradhapura	362.8	57.8	11.9	30.3
Polonnaruwa	149.3	47.9	19.2	32.9
Uva Province				
Badulla	441.2	68.0	10.4	21.6
Monaragala	201.7	67.3	13.2	19.4
Sabaragamuwa Province				
Ratnapura	498.1	49.1	21.9	29.0
Kegalle	358.3	28.8	25.1	46.1

Source: Department of Census and Statistics, *Annual Report of the Sri Lanka Labour Force Survey, 2004* (September, 2006)

ICT

As the conflict cuts off communities in the affected areas, ICT is a useful tool through which connection to the outside world can be reestablished. In addition, it can be used for education, skills training and employment generation. With its decreasing costs and increasing flexibility in adaptation, ICT has the potential to be a practical tool for reaching marginalized communities. ICT creates business opportunities directly, as well as improving information for other sectors such as farming or fishing. Possible businesss models include: village-level ICT shops featuring both voice and Internet services (as in India and Bangladesh); contract work in remote locations for IT companies in Colombo to provide programming services, including work on open-source code; Internet-based accounting services; and small scale Business Process Outsourcing (BPO) operations such as those currently proposed by the Horizon Lanka school in Mahavilachchiya.

USAID is currently supporting the Last Mile Initiative, and complementing programs could be developed to provide: English training; market, weather, and crop protection information for farmers; health information; and government forms and access to other services.

Factors that would need to be taken into design consideration include: access to electricity and the means to pay for similar recurrent costs; existing school and training centers; internet connectivity; security concerns as it relates to allowing communication infrastructure. It is also important that content be tailored to the needs of the local community.

Workforce development

USAID's current workforce development programming focuses on expanding ICT access and skills, developing business skills of young leaders, and promoting English language acquisition. The assessment team recommends continuing these interventions contingent upon their results in FY2007. The team also recommends developing programs tied into the value chain approach of the larger economic growth program. For example, in talking to the TCP cluster groups, the team frequently heard about a shortage of skilled labor in areas like construction, rubber tapping and cinnamon peeling. There are cultural reasons that these positions are not filled, as many educated young people view these jobs as beneath them. At the same time, in conflict-strategic regions these may be excellent opportunities to provide jobs or small business opportunities. The workforce development program should work closely with the private sector program to identify and capitalize on these opportunities as they arise, and should devote resources to dealing with the skills problems faced by the value chain groups, clusters or industry organizations.

The program already targets youth through the Young Entrepreneurs of Sri Lanka. However, programs like YESL frequently self-select motivated young people. The workforce development program should make an effort to reach out to conflict-affected, disaffected and unemployed youth – those who by definition are hard to reach. Programs working with young people from conflict-affected areas should build life skills like leadership, conflict resolution and communication into trainings, as the social structures that would normally develop these skills in young people may have broken down. These programs may also need to provide psychosocial services like trauma counseling.

Should conflict escalate, the workforce development program may also provide a means for accessing youth behind conflict lines. If transport can be arranged, young people can be brought out of the violence for camps focusing both on life and work skills. These camps not only provide training, but a break from the violence and an opportunity to interact with young people from other communities.

Tools

Technical support to business groups

The primary tool for working on Private Sector Competitiveness is providing technical support to the business groups comprising specific value chains, first to help identify key problems that are limiting productivity, value addition, job creation, and growth for the sector (as opposed to individual enterprises) – with particular attention to the distribution of benefits – and second, to devise tractable measures for overcoming those constraints. These measures may involve developing new production techniques, creating new approaches to marketing (such as branding or improved packaging), overcoming financing constraints, or advocating policy reforms.

To develop a productive portfolio of activities to enhance competitiveness and stimulate growth, the implementing team should convene discussions and solicit suggestions from a variety of enterprises, business organizations, cluster groups, both in the economic center and in the target conflict-strategic regions. When promising interventions are identified, the program should undertake pre-feasibility studies, in cooperation with stakeholders, to identify activities with the best prospects of success. For the activities selected, the program can then provide support in many forms, including short-term technical assistance, study tours, co-financing for pilot projects, assistance in developing business plans or seeking financing, capacity building for advocacy of key reforms, or workforce development, – always with an eye on the objective of enhancing private sector competitiveness and delivering strong results in terms of economic growth and distributional balance.

Policy advocacy

Private sector competitiveness in Sri Lanka is significantly affected by a number of policy constraints. Areas for policy advocacy will arise in the course of working with value-chain client groups, and to be fully effective the PSC program will need provisions to deal with these issues. The PSC program should be prepared to strengthen business organizations to analyze the policy constraints on doing business and to better lobby for their interests. In this area as in the others, the linkages from local organizations to the national level dialogue will be critical. The PSC program should develop the capacity of private sector actors (including NGOs, unions and other organizations where relevant) to lobby for reforms that will enhance competitiveness both horizontally (between local actors at the local level) and vertically (from local to national actors).

Policy advocacy activities could address a number of the constraints facing businesses in Sri Lanka. USAID should take a demand-based approach to policy advocacy to ensure that the issues addressed through the program are those most critical to the private sector. This may mean continuing work on trade facilitation. Another major issue the assessment team encountered is the dysfunctional overlapping of ministry responsibilities. One village the team visited had to have representatives on 13 separate committees, each of which required a fee for participation. The village's population was only about 300 people. Duplication of effort by different committees takes away from time spent on productive activities, and thus may be a priority for enhancing productivity. It also indicates inefficiencies in the system that my further hamper private sector activities. A final possibility for advocacy is loosening restrictions on land allocation to allow farmers to expand beyond paddy farming to higher-value crops. This reform would touch on very deep-rooted cultural values around rice farming and therefore would be sensitive, but it might also have real growth-enhancing potential and be worth pursuing. All of these reforms, and others, might need to be accompanied by lobbying for institutional reform to ensure implementation in a non-discriminatory and efficient manner.

Implementers will need to bear in mind that business groups have a tendency to advocate policies that serve their narrow interests but no the public interest – such as advocacy for protectionism, subsidies and monopoly control over certain markets. Not only must the USAID program avoid supporting the private sector in advocating these kinds of policies, but it should also work on educating the private sector about why these measures are counterproductive for the economy overall, and for their own best interests in the medium and long term.

Microfinance & BDS

Providing access to finance to those who have been traditionally excluded or do not have assets as collateral can integrate the poor into productive economic ventures. The start up capital obtained can be used towards a variety of suitable production or service related activities linked to the value chains selected for the overall EG program. Together with access to finance, the program should provide recipients with relevant training in starting up a business, accounting, and good practices in the selected value chain. The program may also organize small farmers or businesspeople where appropriate to better access credit and provide supplies to the value chain.

Currently, the government's Samurdhi social welfare scheme together with government controlled cooperative programs account for about 70% of the microfinance market. However, since the Samurdhi scheme also provides grants to the same households, there is commingling of funds and repayment incentives are distorted. The tsunami has also created distortions with rapid influx of funds in the affected areas. Even under these circumstances, there are other local NGOs and private banks providing sustainable microfinance services in various parts of the county, indicating a demand for services and potential for expansion in this area. In general, the conflict affected north and east are less well served. The government is due to introduce a new Microfinance Act that intends to regulate the market, which could contain a fixed lending rate that will rend microfinance institutions unsustainable without continued subsidies. The Microfinance Network that comprises of most of the practitioners in the field is lobbying the government against such measures.

The team recommends using existing microfinance providers rather than developing new lending schemes, as there has been significant donor investment in microfinance in the past, and the current regulatory environment is uncertain. Organizations like Sarvodaya have developed relatively sustainable models, and would be good partners for a value-chain based approach to integrating microfinance as a tool for improving livelihoods of small businesses, farms and fisheries in conflict-strategic areas.

Strategic cash for work

Cash for work is traditionally seen as an emergency relief intervention, but the team is recommending its use as a strategic tool to develop infrastructure linked to the value-chain in conflict-strategic regions. Many of the regions that would be included in an EG program focused on addressing regional disparity will have significant infrastructure deficits, from irrigation systems to feeder roads to storage facilities. Wherever possible, the EG program should seek to mobilize private sector and community investment to address these deficits. However, in most cases it will be necessary to hire labor to complete the roads. The assessment team recommends using USAID-funded cash for work as a supplement to private investment in those areas where there will be an economic benefit from the infrastructure, a poverty benefit in terms of injecting cash into poor communities, and a conflict benefit gained from employing populations vulnerable to recruitment (such as unemployed youth). Experience from conflict-affected Nepal shows that cash for work programs in green road construction (environmentally friendly, labor intensive rural roads) can play an important role in improving economic infrastructure while infusing cash into poverty–ridden and conflict-affected communities.

In a cash for work program, USAID would offer wages at a level that only unemployed and most needy would be attracted. Programs should also target women for employment wherever possible. This program has the potential to complement the work done by OTI.

Tapping the diaspora

The conflict has resulted in many Sri Lankans, especially from the north and the east, migrating to the West. These migrants continue to have close contact with family members and other community members left behind. Remittances play a large role in sustaining rural households all over Sri Lanka (many have gone to the Middle East) , and the north and east are no exception. The LTTE is financially sustained, in part, through funds sent by the Tamil diaspora. There is a strong interest by Tamil diaspora to want to help their people back home.

This desire could be channeled towards economically productive ventures that show tangible results that benefit the poor in the conflict affected areas. Currently there are ad-hoc efforts by linking up with churches, temples, schools, and local NGOs. Programs that link the private sector and diaspora in activities that are economically viable and show impact on the poor have the potential to be sustainable. The GDA model could be considered here to mobilize diaspora investment. At the same time, USAID will have to be careful both to comply with terrorist financing legislation in ensuring that funds do not reach the LTTE, and also to ensure that funding does not directly or indirectly exacerbate the conflict. While diaspora are motivated to help those who remain back home, they can also be an extremely polarizing influence, as demonstrated by the funding of the LTTE in Sri Lanka. USAID should explore engagement, but should be sure to proceed with caution.

Peace process promotion

After the LTTE bombing of the Colombo airport in 2001, the private sector began to mobilize to push the government and the LTTE to come to a peace agreement. Several different initiatives have emerged over the years since, both among elite actors and within the broader private sector community among the chambers of commerce. Other international donors have supported these initiatives through the Business for Peace Alliance and the Back to Business program, but they are not very well funded. In addition to these two programs, there are also Sri Lanka First and the Business for Peace Initiative. USAID should fund a small program to help facilitate these diverse efforts to lobby for a sustainable peace process, and to encourage the different initiatives to act jointly on issues of common interest. The private sector still has the potential to serve as a neutral voice for peace, and there is a will to do so. This will was demonstrated in the assessment team's meetings with the Business for Peace Initiative after their study tour to South Africa and Northern Ireland. Supporting these initiatives in conjunction with the broader USAID conflict mitigation program would be a low-cost intervention to help promote peace.

How & where: criteria for program engagement

The assessment team was tasked with providing recommendations for a conflict-sensitive economic growth program. The recommendations above were developed to target technical areas that we believe will reduce the likelihood of exacerbating the conflict through USAID assistance, and that may help mitigate the root causes of conflict. However conflict-sensitivity requires more than choosing the right technical focus. Perhaps the most important factors to ensure a conflict-sensitive program in Sri Lanka are careful and deliberate choices on how and where to implement the program.

Scenarios

In light of the history of the conflict, three scenarios emerge as possible operating environments for donors from 2008 forward. The first scenario is the status quo. The government and the LTTE continue to engage in intermittent talks, accompanied by periods of violence, but the conflict does not escalate beyond where it is now, and a political solution does not emerge. Under this scenario, the team recommends implementing the program as described above with expansion into the north and east as the conflict situation allows.

The second scenario is that the situation continues to escalate. All out war breaks out, and there is intensified fighting. Many of the currently accessible areas in the north and the east become war zones. There is further restriction of movement in these areas. The IDP population increases. In this case USAID has three options, depending on the severity of the situation. First, it can refocus on promoting PSC in different target regions while still emphasizing regional equity. It can also focus more attention on working with those private sector who still have on-the-ground mechanisms to trade in the north and east where possible. Second, it can shift EG funding to humanitarian, democracy and conflict mitigation activities to try to intensively support a resolution to the conflict. Removing support for EG activities is clearly not an ideal option, but given limited resources it may be the best choice in an intensifying situation.

In the third scenario, there is a cease fire and a peace agreement. In this scenario, roads are opened, there is free movement of travel, people start returning to their homes, and the military allows reconstruction to begin. USAID is able to work in the LTTE controlled areas. Under this scenario, rapid program expansion into the north and east is essential to start rebuilding links to the rest of the country. The program should also make a deliberate effort to work on community reintegration, building bridges between the different ethnic communities living in close proximity to each other, as well as to national actors. In this case the EG program will need to integrate approaches learned from OTI and other donors who focus on post-conflict community reintegration into more traditional economic growth programming to ensure that a conflict sensitive approach is taken. The assessment team strongly recommends a whole of mission approach for engaging these areas, which is discussed in more detail below.

5. Linkages across USAID portfolio

Conflict in a society is never the result of a single factor, and therefore programs focused on a single sector are unlikely to have significant impact on the root causes of conflict. However using the entire USAID portfolio, including democracy, conflict and economic programming, provides an opportunity to engage the root causes of the conflict in Sri Lanka from all angles. The assessment team strongly recommends taking a 'whole of mission' approach to engagement in at least three geographic areas (and ideally a whole of government approach in coordination with the US Embassy). Limiting coordinated engagement to three areas will reduce the coordination burden on the mission, and allow implementers to pilot coordinated approaches that can then be replicated elsewhere. The mission should work as a team to identify areas in the south for coordination.

Engagement in the north and east should always be taken from a whole of mission approach for two reasons. First, the after effects of the conflict are likely to require programs that can address the systemic problems that remain. An economic program will need to have a strong conflict mitigation and governance focus. Conflict programming will need to address livelihoods. Democracy programming may need to address trauma. Humanitarian programming will cut across all three sectors. Therefore a systemic, coordinated approach is more likely to capitalize on complementarities between different programs. Second, if space opens in the north and east, there will be a deluge of donor funding, bringing multiple new actors into communities previously isolated by the conflict. Implementers working for USAID should therefore all be identified as USAID, to minimize confusion on the part of beneficiaries and other donors. They should also be closely coordinated, as beneficiaries are unlikely to distinguish between different implementers, and therefore will likely assume that any implementer working for USAID will be able to answer all questions about USAID programming. Communities should have a single primary point of contact within USAID who is aware of all activities within a community and can field questions and coordinate responses.